

5.1 Latent defects insurances background

Latent defects insurance, sometimes referred to as building defects or inherent defects insurance, has been readily available from a limited number of major UK and other insurers since 1989. In spite of some increase in its use, there are still many who are not aware of it or do not fully appreciate the benefits it can offer when used early in the procurement of a wide range of projects. Instead, many project sponsors rely only on contract claims and the use of collateral warranties or the [Contracts \(Rights of Third Parties\) Act 1999](#) for security and redress in respect of the consequences of defective design and construction.

As the subject is one that gives rise to more questions and misunderstandings than most other classes of business, a special section has been included to deal with these.

Special considerations apply when a development is wholly or partially residential. Potential mortgagees belonging to the Council of Mortgage Lenders (CML) will almost certainly expect that a particular form of latent defects insurance is in place and is compliant with their requirements. A limited number of insurers provide suitable cover, which will carry far lower excesses, usually a maximum of £1,000 per unit, and may be for a maximum of 10 years. It may even be necessary to issue two policies on the same building, one for the residential parts and one for the commercial parts. The cover for the residential parts will be different in other respects to that summarised below, which is for commercially occupied properties only. The differences should be explained by the broker arranging the cover.

5.1.1 The cover in brief

Imagine that you are building a four-storey office block. During the design stage the wrong information is fed into a computer and as a result understrength beams are used in the roof. During the foundation stage the excavations are inadequate and there is also soil contamination. Whilst the cladding is being installed a workman is supplied with fixings, some of which are of poor quality and not strong enough. In other words there were respective failures in design, workmanship and materials. These existed at practical completion but were undiscovered at that time.

A few months later, after tenants had loaded up the building, the foundations started to subside and crack. The roof started to sag one year after that. Two years down the line some sections of the cladding parted from the framework and a few fell into the car park. After each incident, the owner of the building phoned its insurers and made a claim under their latent defects policy. The claim was handled in much the same way as if the building was damaged by fire. The insurer appointed adjusters, further investigations into the exact cause and the possibility of more damage from the same cause were carried out and estimates for repairs were obtained.

In each case the insurer paid for repairs minus the deductible. It was also established that there would be further and imminent damage as a result of poor quality fixings if they were not replaced. Insurers agreed to pay the cost of installing new ones. The insured did not have to prove negligence against anyone and as subrogation rights had been waived by insurers there was no recovery from the contractors or professionals. In addition the insurers paid the loss of rent as a result of the operation of the rent cesser clause. That is what latent defects insurance can do for a new development. Of course there is a good chance that the faults would have been uncovered by the technical auditors and remedied before completion, in which case a degree of inconvenience and the cost of the deductibles would have been avoided.

5.1.2 The cover in more detail

Those who have purchased latent defects insurance will know that the policy document is relatively short and quite easy to understand once the fundamental concept of the cover is appreciated. Further the cover does not vary much from one insurer to another. The following summary of cover and cost plus details of the technical auditor's role is broadly correct for the class but there are slight variations between insurers and these may change further from time to time.

Therefore the details below are for general guidance only and should not be relied upon for all insurance covers. It is important to complete a proposal form, obtain firm quotations and compare policy wordings before making any decision as to how to proceed.

1. The basic protection

- The basic policy covers actual physical damage to the whole of the building (including the internal and external services) but only when such physical damage is caused by inherent defects that originate in the 'structural parts' of the building. A typical definition of structural parts is shown below but it does vary from one insurer to another.
- An inherent defect is one that exists prior to the date of practical completion but that remains undiscovered at that date and manifests itself during the period of the policy - 10 to 12 years.
- The inherent defect may be in the design, materials or workmanship.
- There is no need to prove negligence against a third party. Whoever is named as the insured in the policy makes a claim against the insurers in the same way as they would claim for fire or storm damage under a property damage policy.

The structural parts are usually regarded as:

- foundations, columns, beams;
- external walls and cladding including glazed curtain walling and non-load bearing facings and their fixings;
- external doors and windows;
- stairs and floors including screeds designed to the strength of the floor of which they form part;
- roof structures;
- other external and internal load bearing elements essential to the stability of the property.

A precise definition will appear in the policy for each insurer. The definitions used by some insurers are wider than that shown above and include features that other insurers would regard as non-structural.

Weatherproofing and waterproofing cover

Damage resulting from ingress of water caused by a defect in the weatherproofing and waterproofing is usually, but not always, included as standard within the basic cover. As inherent defects in wall cladding and roofing are a major source of damage it is always best to include it. There is an exclusion of cover for the first 12 months after practical completion. This

is seen by some as an important exclusion that detracts from the value of the policy. However, it is not possible to remove the restriction. Insurers take the view that the developer must take care to appoint a contractor that will be around long enough to rectify defects during this initial period.

Cover operates in the event that physical damage is caused by water entering the building due to a defect in the weatherproofing envelope of the building at or above ground level or the waterproofing seal below the ground floor.

- **Weatherproofing**

The weatherproofing envelope will normally include:

- roof coverings;
- skylights;
- external walls and cladding;
- external windows and doors excluding moveable elements;
- the ground floor slab.

- **Waterproofing**

- These are the waterproofing elements that are designed to prevent water from entering the building below ground level.

2. Optional covers

Some insurers offer the following in addition to the basic cover:

- Damage to the whole building (including the internal and external services) caused by a defect in the non-structural parts of the building. (In practice such defects are unlikely to have catastrophic consequences.)
- Damage to the whole building caused by a defect in the mechanical and electrical services. (In practice such defects are likely to damage only other parts of the services themselves unless they lead to the operation of a peril such as fire that would, in any case, be covered under an annual all risks material damage policy. However, anything is possible.)

Non-structural parts

These are generally regarded as being all other parts of the building not included under the heading of structural parts, weatherproofing and waterproofing. It is unlikely cover will be available for damage to protective coatings, decorative finishes and floor coverings apart from permanent floor finishes.

As mentioned above, some definitions of structural parts include items that other insurers may define under non-structural parts. Clearly, this is an important differentiator and may influence the choice of insurer.

Mechanical and electrical services

An extension of some insurers' policies cover can be provided for damage caused by inherent defects in:

- heating, ventilating and air conditioning systems and fresh and waste water systems;
- lifts and escalators;
- window cleaning equipment;
- electrical distribution systems (including fixed lighting);
- building management systems and building security equipment (including car park ticket machines and barriers and all types of electrical security doors) but excluding external services.

3. Main exclusions applying to all covers

The main exclusions applying to all covers are as follows:

- works which are outstanding at practical completion;
- use of the property other than that for which it is designed;
- load or application of pressure in excess of the design load or pressure;
- inherent defects discovered during the defects liability (or maintenance) period and the remedying of which is the contractor's responsibility under the terms of the building contract;
- wear and tear and gradual deterioration;
- fire, lightning, explosion, earthquake, storm, flood, escape of water or oil from any tank, apparatus or pipe;
- pollution and contamination;
- war and allied risks.

The fourth exclusion, like the exclusion of weatherproofing and waterproofing cover referred to in 1(a) is perceived by some as too harsh. Insurers take a similar view on why it is justified, although, in practice, they may be prepared to limit its effect.

Exclusion applicable to the mechanical and electrical services cover only

- Testing and intentional overloading of the mechanical and electrical services unless in accordance with manufacturers' or suppliers' instructions

4. What insurers pay for in the event of a claim

In the event of a claim, insurers pay for:

- cost of repairing damage;
- cost of remedial action to prevent imminent damage;
- professional fees;
- cost of debris removal and site clearance;
- extra cost of reinstatement to comply with public authority requirements;
- cost of removing contents whilst work is carried out (there is a limit on this, which may need to be raised).

The above are the main elements of protection but individual insurers' wordings should be examined for the full cover.

5. Who is protected by the insurance policy?

- The policy will usually be in the name of the developer but is freely assignable to new and subsequent owners, lessees or financiers.
- Insurers are usually (but not always) prepared to waive subrogation rights against architects, engineers, contractors and others (but not suppliers) on payment of an additional premium and, usually, the imposition of a higher deductible.

6. The benefits to the insured of buying the cover

- It provides immediate funds for repairs and minimises disruption.
- It means a phone call to a builder rather than a lawyer when damage is discovered.
- It meets the insurance requirements being imposed by many financiers.
- It can be a major advantage when negotiating a sale or letting. In fact, some major tenants are now insisting on the cover being in place.
- The employment of the technical auditors required by insurers to protect their own interests has benefits for the insured as well. The risk of a defect arising is reduced and this is particularly important because if it is a defect that could give rise to damage the insured may be saved from having to pay for losses falling below the deductible as well as the deductible itself if larger claims are avoided.

7. The perceived benefits for the construction project if the cover is purchased

- Developers do not need to rely to the same extent on the project team's professional indemnity insurance.
- The potential for confrontation is reduced.
- There is more peace of mind for all the project team.
- Less time and money is spent on arguing about contract conditions and warranties.
- Innovation is encouraged.
- Everyone can concentrate on getting the actual design and construction right.

8. The premium and technical auditors' fees for basic structural cover plus weatherproofing and waterproofing for 12 years

Typical rates for the basic cover, including the fees, usually range from GBP 0.65% to GBP 1% on the total contract value rising to GBP 2% for completed buildings.

Total cover including structural, weatherproofing, waterproofing, nonstructural and M&E services cover usually costs from 1% to 2% of total contract value inclusive of fees; 10% of the premium is usually paid when the insurance is taken out and the other 90% is paid soon after practical completion. The technical auditors' fees are usually paid in stages as they carry out their tasks during the design and construction period.

Some insurers now offer instalment facilities for the premium over the period of the policy and some may not require the 10% deposit.

Some insurers charge the auditors' fees separately from the premium. Others do not charge the fees separately but pay the auditors out of the deposit premium they receive.

9. The role of the technical auditors

The role of the technical auditors is:

- to monitor the design and construction;
- to check that communication within the project team is effective and that responsibilities are clear;
- to visit the site at regular intervals;
- to clear up problems arising with the contractors or professional team, preferably without the need to involve the insurers or the developers;
- to issue a certificate of approval to insurers at practical completion;
- if applicable, to issue a further certificate relating to weatherproofing/ waterproofing cover for 12 months after practical completion.

The precise role will depend on the demands of individual insurers.

10. Consequential loss covers

When buildings cover is purchased, it is usual for loss of rent to be insured as well. In addition, the basic policy will usually include minimal cover (say £250,000 or 10% of the sum insured) for the cost of removing contents from the building whilst repairs are completed.

It is possible for occupiers to purchase any kind of business interruption cover just as they can for damage by fire or other perils.

It is important that brokers are advised of any likely requirements for consequential loss covers, whether loss of rent or otherwise, at the outset. Such requirements may substantially increase the exposure and influence the markets to be used.

5.2 Latent defects insurance and collateral warranties/third party rights

Whilst latent defects insurance has been increasingly used in the UK, there are still many who do not know about, explore or appreciate its benefits and simply rely only on contract claims and the use of collateral warranties or the [Contracts \(Rights of Third Parties\) Act 1999](#) for security and redress in respect of the consequences of defective design and construction and the assumption of continued availability of professional indemnity insurance for key parties in the project.

5.2.1 The rationale for collateral warranties or third party rights

As mentioned in the opening pages to these guidance notes, the rights and obligations of the participants in a project are governed by the contracts into which the parties enter and the prevailing law.

Where project parties want specific rights relating to a contract to which they are not a party, this is often dealt with by means of a collateral warranty, which creates a direct contractual link to enable the party granted the warranty to enforce certain rights against the grantor under certain circumstances.

This type of contract is dependent upon (collateral to) the underlying principal contract such as

a consultant's appointment or a construction contract, a certified true copy of which must be provided to the beneficiary with the collateral warranty (otherwise the rights under the warranty cannot be clearly interpreted). Typically, the rights dealt with under a collateral warranty relate to workmanship, design standards and specifications and, in respect of parties with a close interest in ensuring the project is completed, an option to 'step-in' and take over the underlying principal contract. An alternative to the use of collateral warranties is available through the Contracts (Rights of Third Parties) Act 1999, the use of which is growing.

It is now an option in some standard form construction contracts. If this statute is used, third party rights may be enshrined in the principal contract (usually in a schedule). The given rights will then automatically be conferred on the specified third party (which may be identified as a class) when the principal contract is executed and dated without the need for a separate contract document to be engrossed and executed by the relevant parties to make those rights enforceable. If the third party is specified as a class (e.g. tenants) a further specific short notice should be given to notify the giver of the rights of the specific third party. Third party rights need negotiating in the same way as the rights under the collateral warranty.

It is common to have to procure at least 30 and often 100 or more collateral warranty documents over various stages of a project. Some of these can prove troublesome (and hence extra costly) to obtain together with the appropriate certified copies of the principal underlying contract. This is particularly the case with subcontractors. Significant effort (and cost) is put into obtaining these, but the real long term value of many collateral warranties is questionable.

5.2.2 The drawbacks to reliance on collateral warranties and third party rights

Once the project has been completed these warranties/rights will often only be of value if the party granting them is still supported by the requisite professional indemnity insurance and even this assumes that the warrantor is still in existence and not insolvent and that the cover is available on reasonable terms. The grantee then has to check every year that the warranties/rights are still so supported. This can be time consuming and creates further paperwork. A claim has to be made and liability established before the injured party will receive any compensation.

In many ways professional indemnity cover and, therefore, reliance on warranties/rights is not a satisfactory solution for parties trying to secure against the risk of something wrong with the design and specification of a completed development over a period of up to 12 years from completion. Workmanship issues will not generally be covered by insurance unless they happen to fall under the all risks policy before completion or the buildings/ property insurance following completion and action would need to be taken against the appropriate party (ultimately the contractor). Often it is difficult to know whether a problem is a design or workmanship issue and this adds to the cost, time and difficulty in seeking and obtaining redress and monetary compensation from the parties who are liable and their insurers.

Even if the collateral warranties/rights are well drafted and professional indemnity cover remains in force for up to 12 years, there is still one major obstacle that has to be overcome before their value is realised. Negligence or fault still has to be proved and that may be both expensive and timeconsuming, with no certainty of a positive result and an uncertain timescale.

One of the big advantages of latent defects insurance is that it is not necessary to prove fault or negligence and compensation is available relatively quickly (and usually without great expense) to the insured provided, of course, the damage suffered is covered under the policy. The existence of this type of policy should be a significant attraction to a purchaser of the development or tenant of the whole or a substantial part of the development with a full repairing covenant. When banks start lending again they may be even keener than before on

seeing the cover in place.

5.2.3 Is latent defects insurance a panacea for developers?

It should not be viewed as a panacea. Latent defects insurance (LDI) is primarily for new build (see *Some questions answered?* para. 5.2.5 below) and cannot replace or cover all categories of liabilities that may otherwise be available via a claim under a collateral warranty/third party rights schedule. There must be physical damage for an LDI policy to respond and, at the moment, it is unlikely to respond to a defect during the rectification or latent defects period. But, if approached in an enlightened manner with a progressive project team there will be ways of getting real value out of a latent defects policy and seeking cost saving elsewhere. It needs a little forethought and planning and it will bring real benefits to, for example, an investor, tenants (with full repairing covenants), management companies and purchasers. Depending on market conditions it may be a factor influencing ease of rental or ease of sale.

5.2.4 Getting best value from the policy

- Research and put into effect a latent defects policy at the outset of the planning and procurement process. This will provide a benefit not only in terms of obtaining the best possible premium for the policy, but also optimising the design and procurement process so costs can be saved.
- Purchase the broadest cover available that is appropriate for the particular project and the needs of the key third parties (this might include mechanical and electrical).
- Investigate and understand the role and responsibilities of the technical auditor and share this knowledge with everyone associated with the project and make use of the technical auditor's role as widely as possible.
- Consider and explore whether the party providing finance might use the technical auditors as their technical monitors and so seek to save costs. Make the approval of the technical auditors a condition of achievement of practical completion and reflect this in the building contract and the contract administrator's appointment.
- Use the *Contracts (Rights of Third Parties) Act 1999* to avoid the need for collateral warranties and thereby save the cost involved in obtaining the completed warranties from consultants and contractors.
- If a waiver of subrogation against the design team and contractors can be purchased from the latent defects insurer, consider and explore a discount on consultant fees and contractor pricing.

5.2.5 Some questions answered

How much does latent defects insurance cost?

The cost will depend on a number of factors but 1% of the cost of construction will usually be enough to buy most of the cover normally purchased as well as paying for the auditor's fee. The premium is initially calculated using a breakdown of figures from the contract price but is adjusted on completion to reflect the cost of rebuilding the completed construction. The cost can be far cheaper for larger developments, mainly because the auditor's fees are proportionately less.

When should I buy it?

Although the cover does not take effect until practical completion or shortly afterwards, insurers should really be approached long before construction commences. Ideally the insurance should be considered at the outset of the planning and procurement process. There will then be plenty of time for the technical auditors to carry out their duties, which may have a bearing on their costs. Furthermore, the sooner the auditors start work the greater the potential benefits of their involvement. Finally, it is cheaper than buying the cover once building work

has started.

Is it possible to buy the cover for buildings where construction has already started or on completed buildings?

The short answer is 'yes'. However, the number of insurers willing to quote may be diminished, the cost will be more, possibly twice as high, the deductible for each and every loss may be doubled as well and some of the benefits of using a technical auditor may be lost. In fact the later the cover is purchased the more it costs and the less the benefits. Loss experience shows that insurers suffer more losses on buildings where the technical auditors had less opportunity to have input into the project and check the design and quality of the workmanship.

Do refurbishments and redevelopments qualify for cover?

The cover is designed for new buildings, but if there are new structures among the works it may be possible to buy protection for the new parts with consequential cover on the rest, should a failure of the new structures lead to damage elsewhere. Success in buying the cover is more likely if only a facade is being retained with a new building behind it. After that it becomes progressively harder.

How long does the policy run?

The period of insurance is usually for 12 years from practical completion. If cover is not purchased until after completion it will still have to expire on the same date as if it had been purchased from completion. Whilst it is possible to buy cover for shorter periods, this rather defeats the objective of the policy and the premium saved may not make it worthwhile.

How do I go about buying the cover and what will happen then?

The first step is to approach an insurance intermediary - preferably one with a good understanding of the subject. You will then be asked to complete a proposal form; this is the best means by which insurers can gather the information they need to assess the risk. A number of documents will also be required, including plans, drawings, ground conditions report, method statements and bar charts. Insurers and auditors will make clear their precise requirements. Insurers will then advise provisional terms, including premium cost, extent of cover on offer, levels of deductible, deposit premium, if any, and the technical auditors' fee. Sometimes the latter is included within the deposit.

Once you have accepted the terms and paid any debits, you will need to supply any further documentation required and the technical auditors will commence work. Their task will be easier if the necessary introductions are made to those working on site, their role is explained and effective lines of communication are drawn up. The auditors will carry out their duties both in their office and on site. They will submit regular reports to the insurers but their intention is that at practical completion you will secure the cover you were seeking from the outset. Any problems they identify will usually be resolved immediately, with as little fuss as possible, and insurers may not even be advised. If there is a disagreement there will be negotiations and in the unlikely event of a compromise not being reached the implications for cover and terms will be explained. An important point is that once you have accepted the insurers' offer of cover, they are bound to issue a policy in accordance with that offer subject to the audit being satisfactory. There should be no nasty surprises at the end!

At practical completion the auditors should be able to sign off the risk as suitable for the policy. Insurers will then advise final terms, which rarely differ from those quoted. Once the premium is paid, a policy will be issued.

Why is the whole building not covered against damage?

The whole building is covered against damage caused by inherent defects as defined. Confusion sometimes arises because under the basic policy cover the inherent defect has to be in the structural parts of the building as defined. In other words there is no cover if the inherent defect is in the non-structural parts. However, some insurers offer non-structural defects as an add-on, although others feel that their policy definition of structural parts is so wide that the risk of a major problem arising from the remaining parts is negligible.

5.2.6 Clearing up the misconceptions

One of the most frustrating things about handling latent defects enquiries is the number of misconceptions that have grown up around it. To a certain extent this is because insurers have not really promoted the cover. In the following paragraphs some of the misunderstandings are stated and the true facts explained.

Does it really cost between 3% and 7% of construction costs?

Cost has been dealt with elsewhere. It is usually 1% or less for a 12-year policy. Nobody will pretend that, even at 1% or less, the cost of the cover is a welcome addition to the budget. It is sometimes possible to pay by instalments and if the cost could be recovered from tenants it could add less than 1% to a tenant's annual outgoings. However, if the insurance was regarded as an integral part of the package and not just as an add-on, there could be savings in other areas.

The cover is not wide enough and does not give developers the certainty they require. There is an argument that two of the policy exclusions, those relating to defects arising in the first 12 months after completion, remove cover that developers really need in order to remove uncertainty about their potential liability for defects after completion. In practice the exclusions refer to defects that should be put right by contractors.

The technical auditors duplicate works unnecessarily (they also add to the cost of construction, interfere with the project and can be the cause of delays. Even without the auditors' involvement, the insurers' requirements for a risk-free building will add to costs)

If all of the above were true the cover would have been dead in the ground years ago. No doubt some of these things are true some of the time, but they are unintentional. The auditors do duplicate some work because they are a checking agency, but the real concern is usually based on the belief that they are duplicating the work of other auditors who may be acting for a tenant or funder. In practice the other auditors are probably working to a different brief and their audits are unlikely to be nearly as thorough. If there is potential and unnecessary duplication this could be tackled and removed by negotiation with interested parties, including the insurers and their auditors. The audit should not increase building costs or cause delay, as the brief is only to make sure the building is erected in accordance with good practice and the building regulations.

The deductible is applied to every claim and this, to a large extent, defeats the objective

of the cover

It depends on the wording of the policy but the usual position is that if there are a series of claims arising from the same cause, the deductible will only apply once.

We already have collateral warranties and always follow up to make sure that professional indemnity covers remain in force for years after the contract is completed

Fine, but that does not guarantee that if damage occurs the cost of repairs can be recovered quickly (or at all if the liable party becomes insolvent) even if negligence can be proved. A claim must be made and proved against the parties with potential liability, who may not be in existence years hence. The damage may still not be repaired in the meantime. A latent defects policy does not require proof of negligence and funds can be available relatively quickly for remedial works.

The *Contracts (Rights of Third Parties) Act 1999* gives all the protection needed

Whilst it is true that this Act may help, there is still a reliance on negligence being proved and the guilty party having sufficient funds available by insurance cover or otherwise. The same drawbacks apply as with collateral warranties (see above).

My professional team sees no advantage for them in the cover being in place and have a fear of being sued by insurers if they get things wrong

There are several points to make here. First, there is no evidence that insurers do sue as a matter of course. In fact experience seems to indicate they only do so in rare circumstances. Secondly, it may be possible to purchase a waiver of subrogation in favour of some parties involved in the project. Thirdly, the activities of the technical auditors should actually reduce the risk for everyone. Fourthly, as latent defects insurance becomes more common then in the longer term this may lead to a transfer of some risks away from PI policies and a subsequent reduction in PI premiums. In the meantime, of course, the professionals will no longer be first in the firing line when insured defects are discovered. Finally, if latent defects cover assumes the right place in the whole insurance umbrella, the professionals might be able to rid themselves of some of the worry and paperwork and devote more time to what they like doing and do best.

5.2.7 Key issues

Do:

- think about latent defects insurance at an early stage in order to minimise the cost and maximise the benefits. The cost can almost double if the insurance is purchased after the foundations have been started;
- think of the cover as an integral part of the procurement and construction process. It should not be an afterthought purchased only to satisfy funders or tenants;
- make sure that all those working on the project know from the outset that cover is being purchased and they understand the advantages and implications for them;
- appoint someone to work with the technical auditors to ensure that the documents and information they require are made available in good time. Ideally, the same person should also liaise with the auditors on site visits;

- make it clear from the outset if any consequential loss cover is required as this will have a bearing on the market placement.

Do not:

- buy it too late and pay higher premiums as well as losing some of the benefits of the auditors' involvement;
- dismiss the insurance out of hand. Experience suggests that once a client purchases the cover, they go on doing so;
- advise insurers of the final sum insured on buildings, on which the premium will be assessed, until you are satisfied that it is calculated in accordance with the requirements of the particular insurer's policy wording. It is important to appreciate how the basic policy cover provides inbuilt protection against inflation in construction costs during both the period that would be required for repair or reinstatement following damage and the period of insurance. Getting it wrong can be expensive in terms of unnecessarily high premiums or inadequate protection.

5.2.8 Further information

For further information see Property Eye, issue 21 (autumn 2006) (Aon Limited) - available for RICS. Hard copies can be obtained from [Aon Limited](#).